SUPREME COURT, U. S. No. 996

Office-Supreme Court, U.S.
FILED
JAN 8 1968
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

BENJAMIN (BENN) MYZEL, *et al.*,
Petitioners,

v.

HARRY FIELDS,
Respondent.

BENJAMIN (BENN) MYZEL, *et al.*,
Petitioners,

v.

SAMUEL H. KING,
Respondent.

BENJAMIN (BENN) MYZEL, *et al.*,
Petitioners,

v.

RITA VERTELNEY, Special Administratrix, etc.,
Respondent.

BENJAMIN (BENN) MYZEL, *et al.*,
Petitioners,

v.

GORDON M. COHEN,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

LEONARD M. LEIMAN
Attorney for Petitioners
1 Chase Manhattan Plaza
New York, N.Y. 10005

REAVIS & MCGRATH
TENZER GREENBLATT FALLON & KAPLAN
of Counsel

TABLE OF CONTENTS

	PAGE
Opinions Below	2
Jurisdiction	2
Questions Presented	2
Statutes Involved	3
Statement	3
Reasons for Granting the Writ	8
A. Introduction	8
B. The Decision Below Conflicts with the Landmark Decision of the Second Circuit in Fischman v. Raytheon Mfg. Co. in Holding Erroneously that Proof of "Scienter" is Not Required in an Action Under Rule 10b-5	11
C. The Decision Below Adopts an Erroneous Standard of Federal Law with Respect to the Measure of Damages, in Conflict with Decisions of Other Courts and with Section 28(a) of the 1934 Act	16
D. The Decision Below Rejecting the Defense of Laches in a Rule 10b-5 Case is in Conflict with the Decisions of Other Courts	18
E. The Decision Below that an Intrastate Telephone Call Supports Federal Jurisdiction is in Conflict with the Decisions of Other Courts	19
F. The Assertion of Liability Against the Corporate Defendant Conflicts with Applicable Law	20

PAGE

G. The Holding Below that a Grossly Negligent Plaintiff Can Recover Under Rule 10b-5 Conflicts with the Second Circuit Decision in List v. Fashion Park, Inc. 21

Conclusion 23

APPENDIX A:

Opinion of United States Court of Appeals ... A1

Order of United States District Court A54

Opinions of the United States District Court .. A59

APPENDIX B-1—Judgment in Case No. 18,341 ..... A80

APPENDIX B-2—Judgment in Case No. 18,342 ..... A81

APPENDIX B-3—Judgment in Case No. 18,343 ..... A82

APPENDIX B-4—Judgment in Case No. 18,344 ..... A83

APPENDIX C—Statutes and Rule A84

AUTHORITIES CITED

Cases

Bailey v. Glover, 21 Wall. 342 (1875) 15

Bredehoeft v. Cornell, 260 F. Supp. 557 (D. Ore 1966) 20

Ellis v. Carter, 291 F. 2d 270 (9th Cir. 1961) 12

Erie R.R. v. Tompkins, 304 U.S. 64 (1938) 16

Estate Counseling Service v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F. 2d 527 (10th Cir. 1962) 16, 17, 18

Fischman v. Raytheon Mfg. Co., 188 F. 2d 783 (1951) 11, 13, 15

Hafner v. Forest Laboratories, Inc., 345 F. 2d 167 (2d Cir. 1965) 22

PAGE

Janigan v. Taylor, 344 F. 2d 781 (1st Cir.), cert. denied, 382 U.S. 879 (1965) 17

Kardon v. National Gypsum Co., 69 F. Supp. 512 (E. D. Pa. 1946) 9
Kohler v. Jacobs, 138 F. 2d 440 (5th Cir. 1943) 21
Kohler v. Kohler Co., 208 F. Supp. 808 (1962), aff'd, 319 F. 2d 634 (7th Cir. 1963) 17, 18

Lennerth y. Mendenhall, 234 F. Supp. 59 (N. D. Ohio 1964) 20
List v. Fashion Park, Inc., 340 F. 2d 457 (2d Cir.), cert. denied, 382 U.S. 811 (1965) 21
List v. Lerner, O.T. 1965, No. 66 9

Minneapolis & St. Louis R.R. Co. v. Winters, 242 U.S. 353 (1917) 20

Nemitz v. Cunny, 221 F. Supp. 571 (N.D. Ill. 1963) 19

Parker v. Baltimore Paint and Chemical Corp., 244 F. Supp. 267 (D. Colo. 1965) 11, 12
Pitofsky v. Brucker, (S.D.N.Y. 1966) CCH Federal Securities Law Reporter, par. 91,715 (1964-66 Transfer Binder) 18

Repass v. Rees, 174 F. Supp. 898 (D. Colo. 1959) ... 20
Richland v. Crandall, 262 F. Supp. 538 (S.D.N.Y. 1967) 12
Rosen v. Albern Color Research, Inc. 218 F. Supp. 473 (E.D. Penn. 1963) 19, 20
Royal Air Properties, Inc. v. Smith, 312 F. 2d 210 (9th Cir. 1962) 18, 19

Sigafus v. Porter, 179 U.S. 116 (1900) 16
Smith v. Bolles, 132 U.S. 125 (1889) 16
Straley v. Universal Uranium & Milling Corp., 289 F. 2d 370 (9th Cir. 1961) 19
Stevens v. Vowell, 343 F. 2d 374 (1965) 12

Thiele v. Shields, 131 F. Supp. 416 (S.D.N.Y. 1955) 12

PAGE

Tobacco and Allied Stocks v. Transamerica Corp., 143 F. Supp. 323 (1956), aff'd 244 F. 2d 902 (3d Cir. 1957) 18
Traer v. Clews, 115 U.S. 528 (1885) 15
Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964) 11, 12, 15
Weber v. C.M.P. Corp., 242 F. Supp. 321 (S.D.N.Y. 1965) 12, 13

Statutes

Securities Act of 1933, 15 U.S.C. 77a, *et seq.* 3, 19
Securities Exchange Act of 1934, 15 U.S.C. 78a, *et seq.* 3
Securities Exchange Act of 1934, § 10(b), 15 U.S.C. 78j(b) ..... 3, *passim*
Securities Exchange Act of 1934, § 27, 15 U.S.C. 78aa 3
Securities Exchange Act of 1934, §28(a), 15 U.S.C. 78bb 17
28 U.S.C. 1254(1) 2

Rule

Rule 10b-5 of the Securities and Exchange Commission ..... 2, *passim*

Miscellaneous

Fleischer, "Federal Corporation Law": An Assessment, 78 Harvard Law Review 1146, 1178 (1965) 15
10 Fletcher, Cyclopedia Corporations §4886 p. 506 21
3 Loss, Securities Regulation 1793 (1961) 17
3 Loss, Securities Regulation 1766 (2d Ed. 1961, and 1962 Supplement) 15
Note, 62 Mich. L. Rev. 1080 (1964) 19
Note, 63 Michigan Law Review 1070 (1965) 15
Restatement of Restitution, §142 (1937) 21
SEC Sec. Exch. Act Rel. No. 3230, May 21, 1942 ... 13

IN THE

Supreme Court of the United States

October Term, 1967

BENJAMIN (BENN) MYZEL, *et al.*,
Petitioners,

v.

HARRY FIELDS,
Respondent.

BENJAMIN (BENN) MYZEL, *et al.*,
Petitioners,

v.

SAMUEL H. KING,
Respondent.

BENJAMIN (BENN) MYZEL, *et al.*,
Petitioners,

v.

RITA VERTELNEY, Special Administratrix, etc.,
Respondent.

BENJAMIN (BENN) MYZEL, *et al.*,
Petitioners,

v.

GORDON M. COHEN,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

Benjamin Myzel, Philip Myzel, Zelman Levine, Clarence S. Levine, Orrin J. Levine, William P. Levine and Lakeside Industries, Inc., hereby petition for a writ of certiorari to review the judgments of the United States Court of Appeals for the Eighth Circuit entered on October 12, 1967, which affirmed the judgments of the District Court entered on November 22, 1965.

Opinions Below

The opinion of the Court of Appeals (App. A, pp. A1-A53, *infra*) is reported at F.2d . The opinions of the District Court are not reported and are included in Appendix A at pp. A54-A79.

Jurisdiction

The judgments of the Court of Appeals were entered on October 12, 1967 (App. B, pp. A80-A83, *infra*). Respondents' petition for rehearing was denied by order dated November 7, 1967. The jurisdiction of this court is invoked under 28 U.S.C. § 1254(1).

Questions Presented

A. Whether a plaintiff must prove scienter, *i.e.* knowledge of the falsity of the representation, as a necessary element in a private action under Rule 10b-5.

B. Whether damages recoverable in a private action under Rule 10b-5 can exceed those determined under the tort "out-of-pocket" measure of damages.

C. Whether laches is an available defense in a private action under Rule 10b-5.

D. Whether an intrastate telephone call can supply the basis for jurisdiction under Section 10(b) and Rule 10b-5.

E. Whether a corporation can be liable in a private action under Rule 10b-5 for violations of that rule committed by officers and shareholders of its predecessor.

F. Whether a grossly negligent director-insider of a corporation, on notice as to all relevant facts concerning the corporation, can recover damages in a private action under Rule 10b-5 arising from the sale by him of the corporation's stock.

Statutes Involved

The relevant provisions of the Securities Exchange Act of 1934, 48 Stat. 881, 15 U.S.C. 78a, *et seq.*, and the Securities Act of 1933, 48 Stat. 74, 15 U.S.C. 77a, *et seq.*, are set forth in Appendix C, *infra*, pp. A58-A59, together with the text of Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. 240.10b-5.

Statement*

These four actions were brought and raise important questions of law under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10(b) thereunder. Jurisdiction of the district court was based upon Section 27 of the Securities Exchange Act of 1934 (48 Stat. 902, 15 U.S.C. §78aa). Respondents are Harry Fields, Samuel H. King, Joseph S. Vertelney** and Gordon M. Cohen. Petitioners are Benjamin Myzel, Philip Myzel, Zelman Levine, Clarence S. Levine, Orrin J. Levine, William P. Levine and Lakeside Industries, Inc. In essence, the actions are based on a claim that respondents were induced to sell shares of stock in Lakeside Plastics and Engraving Co., a small, closely-held local corporation, to petitioners because of misrepresentations or omissions to state material facts (R. 3-5, 18-19, 23-24, 27-29). The stock had been bought seven

---

* Figures in parentheses preceded by the legend "R." refer to pages of Volume I and Volume II of the printed Record; figures in parentheses preceded by the legend "III R." refer to the pages of Volume III of the printed Record containing various exhibits; the legend "P. Exh." refers to Plaintiffs' (Respondents') Exhibits, the legend "D.M. Exh." refers to Defendants (Petitioners) Myzels' Exhibits; and the legend "D. L. Exh." refers to Defendants (Petitioners) Levines' Exhibits.

** Respondent Vertelney died before these actions were tried, and his widow, Rita Vertelney, was substituted in his place as special administratrix (R. 39-40, 68-70). For convenience, reference is made to "Respondent Vertelney" as if he were still alive.

years before for $10,000, and was sold for approximately $6,400 (R. 79-80, 105-06, 150, 316-17, 335-38). The actions were brought nine years later, after a number of corporate changes and developments. The jury found for respondents and awarded damages of $411,000 (R. 804-7), apparently based on an evaluation of the corporation's worth some years after the sales which gave rise to the actions.

Lakeside Plastics and Engraving Co. (LPE) was a Minnesota company organized in 1946 (D.M. Exh. B., III R. 1). Two of the petitioners, Clarence and Zelman Levine, were shareholders, officers and directors of LPE (R. 502; D.M. Exh. A., III R. 2). Respondents were among the original subscribers of common stock at a price of $50 per share and received the following number of shares: Harry Fields (30 shares), Joseph S. Vertelney (100 shares), Samuel H. King (30 shares) and Gordon M. Cohen (40 shares) (D.M. Exh. B., III R. 2-3).

In 1948, Lakeside Plastics Sales Co. ("LPS") was organized in Illinois by two other petitioners, Orrin and William Levine (P. Exh. B., III R. 4). LPS was the sales agency for LPE products (R. 388-391). LPS stock was equally held by Orrin and William Levine (R. 380; P. Exh. 5-A, III R. 4). They were also shareholders and at various times directors of LPE (R. 387, 411, 475-76, 479; D.M. Exh. A., III R. 2).

In its early years, LPE made little financial progress. At the 1949 annual meeting respondent Fields proposed the liquidation of LPE (R. 333-34). Each of the respondents were disappointed with LPE's lack of progress (R. 96, 173, 351-52). In 1952 LPE earned a profit of $7,500 on gross sales of $249,000, but the company still had an earned surplus deficit of approximately $43,000 (P. Exh. 3-D(4), 6, III R. 40-41).

In March, 1953 LPE repaid all accumulated bank indebtedness, and the bank returned LPE stock pledged by the stockholders (R. 175-76, 263). For the first four months of 1953, LPE showed sales of $256,000 and a net profit of approximately $30,000 (R. 556-56; P. Exh. 3-D(5), III R. 48). By year end, however, its profit was only $20,000, and the earned surplus deficit amounted to $23,000 (P. Exh. 3-D(6), III R. 52-53).

In late 1953 and early 1954, respondents sold their LPE stock to either Benjamin or Philip Myzel, the latter acting on behalf of his brother, for approximately $6,400 (R. 79-80, 105-06, 150, 316-17, 335-38). The Myzels paid cash (R. 660-61), the stock certificates were personally delivered (R. 84, 318, 339, 580), and all telephone calls in connection with the transaction were wholly to persons within the same state (R. 79-81, 148-50, 314, 318, 335; A 2).* In 1954, Benjamin Myzel sold some of these shares to LPS for approximately $11,000 (R. 451-57; D.M. Exh. A, III R. 5-6, 9).

Respondents testified that the Myzels had stated that the company was in "bad shape" and on the "verge of bankruptcy," and that Benjamin Myzel had sold or was selling his LPE stock (R. 79, 149, 315, 337). Respondents also testified to their lack of awareness that Philip Myzel was purchasing stock for Benjamin Myzel, and claimed that both Myzels acted for the Levines (R. 3, 18, 24, 28, 587, 592, 626). Respondents indicated they were not told of LPE's increased sales and profits in 1953 (R. 4, 18, 23, 27, 133). Respondents base their claim on these and similar misrepresentations and omissions.

Petitioners' testimony contradicted that of respondents. The Myzels denied making the alleged misrepresentations

---

* The figures in parentheses preceded by the letter "A" refer to the opinion of the Court below, attached as Appendix A hereto.

(R. 622, 659-60). Additionally, petitioners' evidence questioned the materiality of and reliance by the respondents on the alleged misrepresentations and omissions. For example, the increase in LPE's 1953 sales and profits is less significant when it is noted that profits declined by more than half in the following year, and declined again in the year after that (P. Exh. 3-D(7), 3-D(8), 3-C(2), 25-C, 25-D, 25-E, III R. 59-63). In fact, it was not until 1957 that LPE showed a positive earned surplus (P. Exh. 25-F, 66-7; D.M. Exh. DD; III R. 89).

At the time of sale of the LPE-stock, there was no market for the company's shares. The book value of the stock was only $11.65 per share at year-end 1952, $29.40 in 1953, and $31.56 in 1954. By year-end 1957, it had risen only to $58.47. (D.M. Exh. DD, III R. 89.) This contrasts with the jury awards to respondents in amounts ranging from a low of $1,533 per share to a high of $2,266 per share (R. 804-07), more than forty times their original cost.

Moreover, the materiality of the alleged misstatements or omissions is questionable when looked at in connection with respondent Vertelney's right to recover. Vertelney, a business school graduate and experienced executive, was a director of LPE in September, 1953 (R. 300, 462-64, 476-78). He conceded that he found it unnecessary to discuss LPE's affairs with the Myzels since he was "staying fairly well abreast of the company's operation" (R. 314). Furthermore, the minutes of the June, 1953 Board of Directors' meeting indicate that there was considerable discussion about LPE's "present and future sales." (R. 478-80). These facts led the Eighth Circuit to comment that, "If anything, Vertelney was grossly negligent" in relying on petitioner's statements or omissions as inducements to sell his stock (A23).

In 1957 LPE contracted with Benjamin Myzel to pay him $35,000 over a nine year period for consultant services (R. 139-41). This nine-year total of $35,000 was partially in consideration for Benjamin Myzel's transfer of 255 shares of LPE to LPS in 1958 (R. 498, 506, 536).

From the time of sale (1953-1954) onwards respondents were aware of LPE's continued existence (R. 113, 187, 321, 357). Each read a 1959 newspaper article announcing the transfer of LPE from Duluth to Minneapolis (R. 113, 123-24, 187, 321, 358). There was evidence indicating Vertelney remained on LPE's Blue Cross records through 1959 and knew about LPE's expansion (R. 519-20, 715). This pattern of awareness led the court below to question the credibility of respondents' testimony, stating: "The time gap, 1953 to 1962, between the sale and the discovery of the fraud seriously bothers us not only as to Vertelney, but as to all [respondents]" (A23).

By 1958 the Levines and LPS had acquired all of the outstanding shares of LPE (R. 412-13, 420-21; D.M. Exh. A & P. Exh. 15, III R. 8-14). In 1961 Lakeside Industries, Inc. ("LII"), the corporate petitioner herein, became the successor corporation of a merger involving LPE, and LII issued 500,000 shares of its stock to the Levines in exchange for their LPE stock (P. Exh. 4; III R. 21, 122). In 1962, 150,000 shares of LII were sold to the public at $9.00 per share (R. 417, 420).

Vertelney, King and Fields instituted these actions on March 28, 1963. Cohen began his action on July 11, 1963. In each case nine years had elapsed since the alleged misrepresentations and omissions. Trial was by jury, which found in favor of the respondents and awarded damages

totaling $411,000. The trial judge denied petitioners' motion for judgment notwithstanding the verdict or a new trial (A59-A67). The Court of Appeals for the Eighth Circuit affirmed the judgments.

The Court of Appeals held that an intrastate telephone call constitutes a sufficient jurisdictional basis under Section 10(b) and Rule 10b-5; that proof of "scienter," *i.e.*, knowledge of the falsity of a statement, is not required under Section 10(b); that the doctrine of laches was not available as a defense in the action; that the respondents could recover damages measured by the difference between the consideration received and the actual value of the stock at a date substantially beyond the date of the sale; and that the petitioner corporation was liable for the individual petitioners alleged violations of Section 10(b). Thus, respondents, who originally invested $10,000 in 1946 and who sold their stock in 1953-54 for $6,400, were permitted to recover $411,000 in actions not instituted until 1963.

Reasons for Granting the Writ

A. Introduction

These cases arise solely under the private right of action which the lower courts have held is created by Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Rules and Regulations of the Securities and Exchange Commission thereunder. Rule 10b-5 was promulgated by the SEC in 1942, in an effort to fill in by general rule some of the interstices in the overall scheme of Federal securities regulation. Section 10(b) makes it unlawful for any person to employ, in connection with the purchase or sale of any security, "any manipulative or deceptive device or contrivance" in contravention of SEC rules. As relevant here, Rule 10b-5 makes it unlawful, in connection

with such purchase or sale, for any person to make any untrue statements of a material fact or omit to state a material fact.

Beginning in 1946, the courts have held that there is an implied right of civil recovery for violation of Rule 10b-5. The first case, *Kardon* v. *National Gypsum Co.*, 69 F. Supp. 512 (E. D. Pa. 1946), has been followed by a series of cases applying and extending the theory. Use of the Rule has accelerated, to the point where estimates based on reported cases indicate that Rule 10b-5 is generating almost as much litigation as all the other general anti-fraud provisions of the Federal securities laws taken together, and several times as much as the express liability provisions of those laws.

Despite this extraordinary growth of a body of law that is wholly judge-made, this Court has never considered Rule 10b-5 or its scope, although a number of occasions have arisen in which petitions for certiorari have been filed in cases arising under the Rule. In *List* v. *Lerner*, O.T. 1965, No. 66, the SEC appeared as amicus curiae in the certiorari proceedings at the request of the Court. Although the SEC in that case did not believe the writ should issue, as the principal question had been decided correctly and the case involved primarily factual questions, the brief stated (p. 5):

> "The issues have many ramifications, and they may arise in a wide variety of factual situations. They have become more important in recent years, since Section 10(b) and Rule 10b-5 have been relied on with increasing frequency by the Commission to prevent deceptive activities by purchasers of securities and by private parties to secure redress for such activities. This Court has not yet interpreted these

> provisions, and a decision by it would provide helpful guideposts in the development of this important area of the law." (footnote omitted)

The principal interpretive questions in the present case are basic to almost every private action under Rule 10b-5. These are (1) whether proof is required that a misstatement relied on to establish liability has been made with knowledge that it is untrue; that is, whether an innocent misrepresentation is actionable under the Rule; (2) what is the correct rule of damages to apply in an action brought under the Rule by a seller of securities; and (3) whether laches is available as a defense in such an action. These issues, and the others raised in this petition, have been decided in varying ways by the lower courts, which have recognized that conflicts exist among the Circuits. There appears, therefore, the most compelling reason for granting this petition for certiorari—different rules of Federal law now apply in different areas of the nation, and only this Court can prevent the evils of forum-shopping and uneven treatment of litigants in an important area of the law.

Moreover, the decision below has significant impact on petitioners, who have been subjected to a judgment of $411,000, including a judgment of $212,000 in favor of respondent Vertelney, who the court found had been, if anything, "grossly negligent." One of the petitioners held liable in this case is Lakeside Industries, Inc., a publicly held corporation which received no tangible benefit from the putative violation of Rule 10b-5. Thus, the present case not only presents issues of general importance to the administration of the Federal securities laws, it is itself a striking illustration of the need for this Court to formulate proper standards in this type of litigation.

B. The Decision Below Conflicts with the Landmark Decision of the Second Circuit in *Fischman* v. *Raytheon Mfg. Co.* in Holding Erroneously that Proof of "Scienter" is Not Required in an Action Under Rule 10b-5

The court below held that "Proof of 'scienter,' i.e., knowledge of the falseness of the impression produced by the statements or omissions made, is not required under Section 10(b) of the Act." (A19.) This holding is in direct and irreconcilable conflict with the decision of the Second Circuit in *Fischman* v. *Raytheon Mfg. Co.*, 188 F. 2d 783 (1951), where the court, in a carefully-reasoned opinion of first impression, held that proof of fraud is required in an action under Rule 10b-5. The decision below is also in conflict with *Trussell* v. *United Underwriters, Ltd.*, 228 F. Supp. 757 (D. Colo. 1964) and *Parker* v. *Baltimore Paint and Chemical Corp.*, 244 F. Supp. 267 (D. Colo. 1965).

The opinion in the court below obscures the issue of "scienter" by confusing knowledge of the falsity of a representation with the intent with which the representation is made. As the court noted, the District Court's charge to the jury required a finding of "misrepresentations or omissions" made with "the intent of inducing plaintiffs to sell their stock." (A19.) An innocent misrepresentation can be made with such an intent, however, if the person making the representation has an erroneous belief in the truth of the statement or omission and it is made in the context of inducing a securities transaction. In those circumstances, there would be no fraud—*i.e.*, no "scienter"—and no cause of action under the rule adopted by the Second Circuit in *Fischman* v. *Raytheon Mfg. Co.* The court below, on the other hand, concluded that a finding of intent to induce the purchase of stock required "in effect" a finding that the petitioners be "conscious wrongdoers." There is no sup-

port whatever in the charge for this conclusion. The charge plainly permitted the jury to find liability if there was a material misstatement or omission, without requiring any finding that the defendants were aware of the falsity of the statement or had any intent to defraud the plaintiff. (See R. 782, 786.)

In holding that "proof of scienter . . . is not required under Section 10(b) of the Act," the court followed *Ellis* v. *Carter,* 291 F. 2d 270 (9th Cir. 1961), which adopted the principle that misrepresentations, to be actionable under Rule 10b-5, need not be knowingly made. The rule that has emerged in the Eighth and Ninth Circuits, therefore, stands in opposition to that adopted in 1951 by the Second Circuit and consistently followed since in that court, which as a commercial and financial center deals with a significant number of all actions brought under Rule 10b-5. See, *e.g., Weber* v. *C.M.P. Corp.,* 242 F. Supp. 321 (S.D.N.Y. 1965); *Thiele* v. *Shields,* 131 F. Supp. 416, 419 (S.D.N.Y. 1955); cf. *Richland* v. *Crandall,* 262 F. Supp. 538, 553 n. 12 (S.D. N.Y. 1967). There seems no likelihood that the conflict among the circuits can be resolved without intervention by this Court. The writ should be granted so that this Court can settle the issue, which is of vital importance not only in the present case, but in every case brought under Rule 10b-5.*

---

* The Tenth Circuit in *Stevens* v. *Vowell,* 343 F. 2d 374 (1965), may have indicated agreement with the Ninth Circuit in not requiring proof of scienter. The confusion in this area and the need for clarification by this Court, however, is illustrated by *Parker* v. *Baltimore Paint and Chemical Corp.,* 244 F. Supp. 267 (D. Colo. 1965), a later case arising in the Tenth Circuit. The court in *Parker* considered the *Stevens* consideration of the "scienter" question as dictum and reaffirmed the District Court's prior decision in *Trussell* v. *United Underwriters, Ltd.,* 228 F. Supp. 757 (D. Colo. 1964), which analyzed the issue at length and held that scienter is an essential element of an action under Rule 10b-5.

Determination of whether "scienter" should be required under Rule 10b-5 requires an examination of the system of securities regulation imposed under the several Federal securities laws. The opinion in *Fischman* v. *Raytheon Mfg. Co.* was written by Circuit Judge Frank, himself a former Chairman of the Securities and Exchange Commission. Judge Frank's conclusion rests on a compelling analysis of the Congressional policies embodied in the securities laws themselves. Indeed, even the SEC release announcing the adoption of Rule 10b-5 stated that the rule prohibited "individuals or companies from buying securities *if they engage in fraud in their purchase.*" (SEC Sec. Exch. Act Rel. No. 3230, May 21, 1942; emphasis added.)

The conflict between the Second and Ninth Circuits has been recently recognized by Judge Wyatt of the United States District Court for the Southern District of New York, who found that the rule in *Fischman* v. *Raytheon Mfg. Co.* is still binding in the Second Circuit, and that *Ellis* v. *Carter* "reaches a contrary result" on the issue of whether misstatements which might be innocent or negligent are actionable under Rule 10b-5. *Weber* v. *C.M.P. Corp.*, 242 F. Supp. 321 (S.D.N.Y. 1965). The result in *Ellis* v. *Carter* is, of course, exactly the result reached by the Eighth Circuit in the present case. Judge Wyatt summarized the issue, and the reasons for the Second Circuit rule, this way (242 F. Supp. at p. 325):

> "But were I free to do so, I would not follow *Ellis* v. *Carter* which, with great deference, seems to me (on the specific point under discussion) to be in error. The 1933 and 1934 Acts are closely related, were adopted close together in point of time, and

were part of the same legislative program. The first Act dealt primarily with the distribution of securities; the second Act dealt primarily with securities transactions after initial distribution had been made. To give a private remedy under Rule 10b-5 and Section 17(a) is simply to duplicate (without their restrictions) the express liabilities created by Sections 11 and 12 of the 1933 Act *unless* the remedy under Section 17(a) and Rule 10b-5 be made different. The *Fischman* decision at least recognized this aspect and did something about it. The *Fischman* decision says that if you rely solely on innocent or negligent misstatements, your sole remedy is under Sections 11 and 12 of the 1933 Act with the short statute of limitations and other procedures laid down by Congress. If you wish to avoid those limiting procedures, you must allege and prove real fraud, that is, scienter. Such an analysis seems far more reasonable to me than the broad generality of *Ellis* v. *Carter.*"

The facts in the present case provide an excellent opportunity for this Court to examine this issue of "scienter," since it is of critical importance in this case in determining liability. There was conflicting testimony with respect to substantially all the alleged misrepresentations and omissions involved; it must be remembered that the statement of the case by the Court of Appeals in its opinion assumes all factual issues as having been resolved against the defendants. On the evidence, however, the jury might have found that petitioners made statements about the financial condition of LPE, that these statements were not accurate but that petitioners honestly believed them to be true, and that these were the only misrepresentations or omissions involved. Under the District Court's charge, the jury was

required to base liability solely on that finding. Under *Fischman* v. *Raytheon Mfg. Co.* and *Trussell* v. *United Underwriters, Ltd., supra,* the finding would not establish a violation of Rule 10b-5.

Moreover, the issue of scienter should in this case determine whether the action can be maintained at all. Respondents brought these actions against petitioners in 1962 and 1963, almost ten years after the acts complained of were allegedly committed. The statute of limitations would plainly have run, were it not for the rule of *Bailey* v. *Glover,* 21 Wall. 342 (1875), which tolls the statute until plaintiff has discovered or should reasonably have discovered the fraud. The *Bailey* rule applies, however, only where there has been fraud or concealment; see *Traer* v. *Clews,* 115 U.S. 528 (1885). Thus, the jury should have been instructed that if no scienter were found, the action is barred by the statute of limitations.

A number of commentators have indicated that the view of the Second Circuit, or a rule which requires some degree of scienter to establish liability, is the correct one. See, *e.g.,* Fleischer, *"Federal Corporation Law": An Assessment,* 78 Harvard Law Review 1146, 1178 (1965); 3 Loss, Securities Regulation 1766 (2d Ed. 1961, and 1962 Supplement); Note, 63 Michigan Law Review 1070 (1965). With this support for the Second Circuit's approach, the conflict among the Circuits will be perpetuated indefinitely unless this Court grants the petition for certiorari and resolves the issue.

C. The Decision Below Adopts an Erroneous Standard of Federal Law with Respect to the Measure of Damages, in Conflict with Decisions of Other Courts and with Section 28(a) of the 1934 Act

The courts below erred in permitting recovery by the sellers of an amount greater than the difference between the value of the stock at the time of the sale and the amount of consideration received. The measure of damages allowed by the court permitted the jury to consider later accretions in value, a standard which permits a plaintiff to initiate suit after waiting until the moment of maximum speculative advantage occurs. This holding conflicts with *Estate Counseling Service* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F. 2d 527 (10th Cir. 1962), which held that the measure of damages in an action under Rule 10b-5 is the "out-of-pocket" rule.

In fashioning an implied right of action under the general standards of Rule 10b-5, the lower courts have created, and are creating, a body of Federal corporate common law, much like the development of Federal law before *Erie R.R.* v. *Tompkins*, 304 U.S. 64 (1938). The measure of damages historically adopted in Federal cases involving common law actions for fraud and deceit has been the "out-of-pocket" rule. *Smith* v. *Bolles*, 132 U.S. 125 (1889). As this Court stated in *Sigafus* v. *Porter*, 179 U.S. 116, 123 (1900), quoting from an earlier decision of the Eighth Circuit, "The true measure of the damages suffered by one who is fraudulently induced to make a contract of sale, purchase, or exchange of property, is the difference between the actual value of that which he parts with and the actual value of that which he receives under the contract. It is the loss which he has sustained, and not the profits which he might have made by the transaction. It excludes all speculation, and is limited to compensation."

Estate Counseling Service v. *Merrill Lynch, Pierce, Fenner & Smith, Inc., supra,* held that this common law rule is still applicable in actions under Rule 10b-5, as did the court in *Kohler* v. *Kohler Co.*, 208 F. Supp. 808 (1962), aff'd, 319 F. 2d 634 (7th Cir. 1963). See also 3 Loss, Securities Regulation 1793 (1961), which accepts the out-of-pocket rule as the proper measure of recovery in a Rule 10b-5 case.

The broader remedy permitted by the court below is derived from *Janigan* v. *Taylor,* 344 F. 2d 781 (1st Cir.), *cert. denied,* 382 U.S. 879 (1965). The court in *Janigan* posed the issue as whether to grant a "necessary" windfall to the "conscious wrongdoer" or to the party defrauded. Based on this simplistic choice between the innocent victim and the knowing defrauder, the court in *Janigan* made the rather obvious decision. But the *Janigan* rule is one which is specifically applicable only to "conscious wrongdoers." As urged in this petition, the instructions to the jury in this case permitted the finding of a violation of Rule 10b-5 without a finding of "scienter." See pp. 11-12, *supra.* The *Janigan* rule is thus inapplicable to the facts and posture of this case, and in adopting that rule the court below erred.

Moreover, the allowance of damages in an amount greater than that permitted under the "out-of-pocket" rule conflicts with Section 28(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78 bb, which specifically establishes the outer limits of recovery in an action under Rule 10b-5. Section 28(a) provides that "no person permitted to maintain a suit for damages under the provisions of this title shall recover . . . a total amount in excess of his actual damages on account of the act complained of." The court below stated, ". . . we feel the only effect of this provision is to prohibit punitive damages . . . ," and permitted a re-

covery greater than that of the "out-of-pocket" standard. This decision conflicts with the Federal rule adopted by other courts. See *Estate Counseling Service* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc., supra,* 303 F.2d at p. 533, and *Kohler* v. *Kohler Co., supra,* 208 F. Supp. at p. 825. These cases squarely hold that Section 28(a)'s language of "actual damages" incorporates the "out-of-pocket" measure of recovery.

D. The Decision Below Rejecting the Defense of Laches in a Rule 10b-5 Case is in Conflict with the Decisions of Other Courts

The court below erred in holding that the defense of laches was not applicable to a Rule 10b-5 cause of action "properly tried at law to a jury." (A35.) The ruling is in conflict with the decisions of other courts. See *Royal Air Properties, Inc.* v. *Smith,* 312 F. 2d 210, 214 (9th Cir. 1962); *Tobacco and Allied Stocks* v. *Transamerica Corp.,* 143 F. Supp. 323 (1956), aff'd 244 F. 2d 902 (3d Cir. 1957); *Pitofsky* v. *Brucker,* (S.D.N.Y. 1966) CCH Federal Securities Law Reporter, par. 91,715 (1964-66 Transfer Binder). The Ninth Circuit in *Royal Air Properties, Inc.* squarely held that in a Rule 10b-5 action laches was an available defense. The District Court in *Tobacco and Allied Stocks* concurred and additionally decided that laches was an appropriate defense whether the claim is characterized as one in law or equity, such a characterization being deemed by the court to be an unnecessary throwback to common law pleading rules. See *Tobacco and Allied Stocks* v. *Transamerica Corp.,* 143 F. Supp. at 327.

The court below prohibited the laches defense on the ground that the nature of the claims was one at law. This characterization was made despite the fact that the plain-

tiffs claimed alternatively damages at law and rescission in equity. Moreover, the equitable defense of laches was considered inapplicable despite the fact that the ultimate relief granted was equitable, *i.e.*, the *Janigan* rule of permitting the one defrauded to keep any windfall as a result of accretions to the value of stock after the date of sale.

The court below relied on *Straley* v. *Universal Uranium & Milling Corp.*, 289 F. 2d 370 (9th Cir. 1961), an action brought under Sections 5 and 11 of the Securities Act of 1933, 15 U.S.C. 77a, *et seq.*, both of which are governed by a statutory period of limitations. Rule 10b-5, however, contains no statutory limitations period. The Ninth Circuit itself in *Royal Air Properties, Inc., supra,* refused to follow its earlier decision in *Straley,* stating, " . . . where there is no applicable federal statute of limitations, as in a Section 10(b) action, there is no evidence of a Congressional intent to exclude the traditional doctrine of laches." 312 F. 2d at p. 214.

E. The Decision Below that an Intrastate Telephone Call Supports Federal Jurisdiction is in Conflict with the Decisions of Other Courts

Section 10(b) and Rule 10b-5 provide that "the use of any means or instrumentality of interstate commerce or of the mails . . ." constitutes a basis for federal jurisdiction. The court below, relying upon *Nemitz* v. *Cunny,* 221 F. Supp. 571, 573 (N.D. Ill. 1963), held that the use of a telephone to call another wholly within the same state constitutes sufficient jurisdiction because the telephone is an "instrumentality of interstate commerce." The decision below and the rule of *Nemitz* conflict with the holding in *Rosen* v. *Albern Color Research, Inc.* 218 F. Supp. 473 (E.D. Penn. 1963). See also Note, 62 Mich. L. Rev. 1080 (1964).

The Court in *Rosen*, citing Mr. Justice Holmes's analysis in *Minneapolis & St. Louis R.R. Co.* v. *Winters*, 242 U.S. 353, 357 (1917), reasoned that whether an object is to be considered an "instrumentality of interstate commerce" depends entirely upon the use to which it is put. In the context of a telephone, the test therefore would be whether the call was to another within the state or whether it was indeed used in interstate commerce.

The question has often arisen before the Federal courts. See *Bredehoeft* v. *Cornell*, 260 F. Supp. 557 (D. Ore 1966); *Lennerth* v. *Mendenhall*, 234 F. Supp. 59 (N. D. Ohio 1964); *Repass* v. *Rees*, 174 F. Supp. 898 (D. Colo. 1959).

Although the court below also predicated jurisdiction on the "delivery of checks written by the Illinois Corporation on Chicago, Illinois banks to a Minnesota citizen," the trial court's instructions to the jury permitted a finding that petitioners used merely the telephone to purchase respondent's stock (R. 785-786). Thus, jurisdiction could well be predicated on the use of the telephone alone. Petitioners urge this court to grant certiorari in order to settle this conflict among the courts.

F. The Assertion of Liability Against the Corporate Defendant Conflicts with Applicable Law

The court below held that Lakeside Industries, Inc., as the successor to LPE, is liable for the individual defendants' alleged violations of Rule 10b-5. LII's liability is predicated on misrepresentations or omissions made by a stockholder or director of LPE solely for his own benefit and not for that of the corporation. LPE had no concern over who owned its shares at the time of the sales by respondents. Imposing liability on LII, as successor to LPE, conflicts with the well-established rule that a corpo-

ration is not liable for misrepresentations or omissions made by an officer or director in connection with the selling or buying of stock in the corporation for the officer or director's own personal account. See *Kohler* v. *Jacobs,* 138 F. 2d 440, 443 (5th Cir. 1943), 10 FLETCHER, CYCLOPEDIA CORPORATIONS §4886 p. 506; RESTATEMENT OF RESTITUTION, §142 (1937).

Since 1962, 150,000 additional shares of LII have been issued to the public. The alleged acts of the individual petitioners were the acts of former stockholders of LPE and not those of the corporation. To penalize the corporation and all its public stockholders for the acts of these particular stockholders is a novel and inequitable notion.

G. The Holding Below that a Grossly Negligent Plaintiff Can Recover Under Rule 10b-5 Conflicts with the Second Circuit Decision in *List v. Fashion Park, Inc.*

Respondent Vertelney was found by the Court of Appeals to have been, if anything, "grossly negligent." (A23)

The holding below that Vertelney nevertheless could recover, even though grossly negligent, conflicts with *List* v. *Fashion Park, Inc.,* 340 F. 2d 457 (2d Cir.), *cert. denied,* 382 U.S. 811 (1965). *List* held that the reliance necessary for an action under Section 10(b) is not only that the plaintiff in fact relied upon the misrepresentation, but that "a *reasonable man* would also have acted upon the fact misrepresented." 340 F. 2d at p. 462. Since Vertelney was an experienced man with a degree in business administration, and a director of LPE at the time of the alleged misstatements and omissions, he could not in these circumstances be said to have reasonably been misled or to have relied upon the alleged misstatements.

In addition, the District Court charged correctly that Vertelney, because of his position as a director, was an "insider" as a matter of law. An insider who sells his stock cannot recover under Section 10(b) where his claim is based on facts which were equally available to both buyer and seller. Cf. *Hafner* v. *Forest Laboratories, Inc.*, 345 F. 2d 167 (2d Cir. 1965). Furthermore, because of his position as a director, and his presence at relevant directors' meetings, where the nature of the business and its prospects were thoroughly discussed, Vertelney, as a matter of law, was on notice as to any falsity in any of the alleged representations or omissions. It cannot be said that one who has notice of any such falsity meets the criterion of reliance upon material facts which are "misleading" within the meaning of Rule 10b-5. Any misstatements or omissions could not reasonably have been material to or relied on by a man with Vertelney's experience and admitted personal knowledge of the corporation's affairs. When liability is imposed under the circumstances present in this case, Rule 10b-5 becomes a trap for the unwary. In granting Vertelney's claim for damages, the court below committed reversible error.

CONCLUSION

The decision below conflicts on numerous issues with decisions in other Federal courts. This Court has never considered the many questions arising under Rule 10b-5. The increasing frequency of cases arising under the Rule, and the uncertainty which now pervades this area of the law, point to the urgent need for this Court to resolve these issues at this time.

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

LEONARD M. LEIMAN
Attorney for Petitioners
1 Chase Manhattan Plaza
New York, N.Y. 10005

REAVIS & MCGRATH
TENZER GREENBLATT FALLON & KAPLAN
Of Counsel

January 8, 1968